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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946

No. 373

PETIT ANSE COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

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COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner, Petit Anse Company, a corporation organized and existing under the laws of the State of Delaware, respectfully prays that a writ of certiorari issue to review that part of a judgment of the Circuit Court of Appeals for the Fifth Circuit which affirmed a decision of The Tax Court of the United States determining deficiencies in income and excess profits taxes of the petitioner.

Opinions Below

The memorandum findings of fact and opinion of the Tax Court (R. 47-69) are not reported but are published in Commerce Clearing House Tax Court Service as Dec.

14,230 (m). The opinion of the Circuit Court of Appeals (R. 127) is not yet reported.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered on May 9, 1946 (R. 131). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented

1. Whether interest paid on debentures having a fixed maturity date and with interest payable at a fixed rate out of earnings and non-cumulative is properly deductible from gross income as interest on indebtedness, or whether such interest may be considered dividends on stock.

2. Although it may be reasonably possible for the Tax Court of the United States to conclude in one case that interest paid on debentures is interest on indebtedness and in another case that interest paid on debentures constitutes dividends on stock, where the facts of the two cases are substantially different, is it reasonably possible or in accordance with law for the Tax Court to reach opposite conclusions on that question in two cases where the material facts are substantially identical?

Statutes and Regulations Involved

The applicable provisions of the statutes are Section 23 (b) of the Revenue Act of 1936, c. 690, 49 Stat. 1638 (applicable to the year 1937); the same subsection of the Revenue Act of 1938, c. 289, 52 Stat. 447 (applicable to the year 1938), and of the Internal Revenue Code, c. 2, 53 Stat. 1 (applicable to the year 1939); and Section 1141 (a) and (c) of the Internal Revenue Code. Section 23 (b) is in all material respects identical in each of the

applicable acts and such subsection of the Revenue Act of 1936 is as follows:

"SEC. 23. DEDUCTIONS FROM GROSS INCOME

In computing net income there shall be allowed as deductions:

* * * * * * *

(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, * * *."

Section 1141 (a) and (c) of the Internal Revenue Code is as follows:

"SEC. 1141. COURTS OF REVIEW

(a) JURISDICTION.—The Circuit Court of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Board, except as provided in section 239 of the Judicial Code.

(c) POWERS

(1) To affirm, modify or reverse.—Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require."

The pertinent provisions of Treasury Regulations 94, issued under the Revenue Act of 1936, which in all material respects are the same as the corresponding provisions of Regulations 101, issued under the Revenue Act of 1938 and Regulations 103 (1939) issued under the Internal Revenue Code are as follows:

"Art. 23 (b)-1. Interest—interest paid or accrued within the year on indebtedness may be deducted from gross income * * *

* * * * * * *

So called interest on preferred stock which is in reality a dividend thereon cannot be deducted in computing net income."

Statement

Petitioner is a corporation organized May 15, 1924 under the laws of Delaware. During 1937, 1938 and 1939, the years here in issue, petitioner was the owner of Avery Island, Louisiana, under the surface of which is a salt dome. Prior to the reorganization of petitioner in 1931 it owned the underlying salt, and Avery Planting and Improvement Company, a Louisiana corporation, owned the surface property and all other property on the island except the salt. Petitioner then had outstanding 15,000 shares of its no par value capital stock (R. 47-52).

In 1931 petitioner and Avery Planting and Improvement Company entered into and carried out a recapitalization and reorganization agreement whereby the 15,000 shares of capital stock of petitioner then outstanding were surrendered and cancelled; and petitioner issued to its stockholders pro rata 6,000 shares of its no par value capital stock and $1,000,000 face amount of its debentures; petitioner also issued to the stockholders of Avery Planting and Improvement Company 4,000 shares of its no par stock in exchange for the stock of Avery Planting and Improvement Company, and Avery Planting and Improvement Company was then liquidated and dissolved, and the liquidators of that company transferred all of its assets to petitioner in exchange for the surrender by petitioner of the stock of Avery Planting and Improvement Company. Thereafter petitioner had outstanding 10,000 shares of no par value capital stock and $1,000,000 face amount of debentures (R. 52-53), said amount being subsequently reduced by payments on account of principal.

The terms of the debentures are set forth in the debentures and in the indenture under which they were issued. The debentures were dated November 1, 1931, were designated "Eight Percent Registered Non-Cumulative Fifty Year Income Gold Debentures," and contained an unconditional promise to pay the principal amount on November 1, 1981. The debentures were registered and were issued under and subject to the said indenture between the petitioner and named individuals as trustees (Ex. 34).

The interest on the debentures was payable quarterly and was payable only if and to the extent that the surplus net income of petitioner was sufficient for the payment. The obligation to pay interest each year at the rate of 8% to the extent of surplus net income was unconditional. Surplus net income was defined as gross earnings less specified operating expenses, including taxes. If the amount of such surplus net income for any year was insufficient to pay in full the interest for that year, provision was made for application of such amount *pro rata* to the payment of debentures outstanding, and there was no obligation on petitioner to make up the deficiency in subsequent years, even though there was sufficient surplus net income in such subsequent years. If there was surplus net income in any year in excess of the amount paid as interest for that year and the amount paid was less than 8%, the Board of Directors was authorized at any time after the termination of such year to use such surplus net income to make payments on account of unpaid interest up to 8% for such year (Art. Third). The debentures were redeemable by petitioner at its option on 60 days' notice to the registered holders (Art. Fourth).

If petitioner defaulted in the payment of any interest due on the debentures and the default continued for 60 days or if it defaulted in the payment of principal at ma-

turity or when called for payment under any provision of the said debentures and indenture, the trustees were authorized, and upon the written request of registered holders of 60 per cent of the outstanding debentures they were required, to declare the principal of all the debentures to be forthwith due and payable (Art. Fifth).

It was provided that the indenture should not be recorded or registered in any public office but that the original should be filed with the trustees (Art. Eighth). The indenture recited that the only parties interested in petitioner, as owners of the debentures, were descendants of Daniel Dudley Avery and that it was the purpose and intention of all the registered owners that no party should become the owner of any of the debentures except descendants of Daniel Dudley Avery, and that each registered holder agreed that before selling any of his debentures to any party other than a registered holder he would first offer them to petitioner and that petitioner should have an option for 30 days to purchase them at the same price at which they were offered *bona fide* for sale to such other party (Art. Eleventh).

It was agreed that petitioner and all its property should be liable for the payment of the debentures (Art. Twelfth). The debenture holders were not given any right to vote or otherwise participate in the management of petitioner, and the debentures were not made subordinate to any other debts of petitioner.

Petitioner in its income and excess profits tax returns for the years 1937, 1938 and 1939, deducted the interest paid by it on the debentures in those years. The respondent disallowed the deduction and determined deficiencies in petitioner's taxes, and the Tax Court in its findings of fact and opinion handed down on October 27, 1944 (R. 47-69) and its decision entered December 27, 1944 (R. 69-70) sus-

tained the respondent's disallowance of the interest deduction. The Tax Court's findings of fact and opinion were in memorandum form, rendered by one Judge and were not reviewed by the entire court. The Circuit Court of Appeals for the Fifth Circuit in its opinion handed down on May 9, 1946, and by its judgment entered on the same day, affirmed the Tax Court's decision on this issue, on the assumed authority of the decision of this Court in *Dobson* v. *Commissioner*, 320 U. S. 489 (1944).

Specification of Errors To Be Urged

The Circuit Court of Appeals for the Fifth Circuit erred:

(1) In affirming the decision of the Tax Court holding that the interest paid by the petitioner on its debentures in the years 1937, 1938 and 1939 is not an allowable deduction in computing the petitioner's net income for income and excess profits tax purposes for those years.

(2) In holding that the decision of the Tax Court disallowing the interest deduction must be affirmed on the authority of the decision of this Court in *Dobson* v. *Commissioner*, 320 U. S. 489.

(3) In failing to review the decision of the Tax Court to determine whether it was in accordance with law, thereby disregarding the provisions of Section 1141(c) of the Internal Revenue Code.

Reasons for Granting the Writ

I

(a) The Circuit Court of Appeals for the 5th Circuit has decided an important question of Federal income tax law which has not been and should be settled by this Court; and

(b) Its decision on that question is in conflict with the decision of this court in *Dobson* v. *Commissioner*, 320 U. S.

489 (1944) and with *John Kelley Co.* v. *Commissioner*, 326 U. S. 521 (1946); and

(c) The question decided by the Tax Court and affirmed by the said Circuit Court of Appeals, as decided by the Supreme Court in the *Kelley* case, was a question of law and was therefore reviewable by the Circuit Court of Appeals and the decision of that court is reviewable by this Court under Internal Revenue Code Sec. 1141 (c).

The Circuit Court of Appeals in deciding the question at issue did not review the decision of the Tax Court but merely said:

> "Whether or not the payments made to the stockholders under the debentures were payments of interest on an indebtedness or mere distribution of earnings to stockholders presents a mixed question of law and fact which decision we do not think is either arbitrary, unsupported, unreasonable, or unallowable, and the holdings of the Tax Court thereon will not be disturbed. *Dobson* v. *Commissioner*, 320 U. S. 489."

It is implicit in the holding of the Court below that review of the decision of the Tax Court herein is barred by the decision of this Court in the *Dobson* case. It is submitted that the *Dobson* decision does not support such holding.

In the *Dobson* case the taxpayer during the taxable year recovered from the seller of stock to him an amount on account of the purchase price, on the ground of fraud. He had sold the stock in a prior year at a loss and had deducted the loss on his income tax return for that year, but because of other deductions it did not result in a tax benefit. The Board of Tax Appeals (now the Tax Court), 46 B. T. A. 770, held that since the deduction of the loss in the prior year did not result in a tax benefit, the amount of the recovery was not taxable income. This Court affirmed the Board of Tax Appeals and said that whether the Tax

Court's decision is in accordance with law "is a clear-cut question of law and is for decision by the courts" (p. 493).

This Court also said as to decisions of the Tax Court (p. 501):

> "Its decision, of course, must have 'warrant in the record' and a reasonable basis in the law. But 'the judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body.' "

It follows from this Court's decision in the *Dobson* case, as well as from Sec. 1141 (c) of the Code, that appellate courts must examine decisions of the Tax Court to determine whether they are in accordance with law and unless there is warrant in the record and a reasonable basis in the law for a decision of the Tax Court, the appellate court must review and reverse such decision.

It appears from the decision of this Court in *John Kelley Co.* v. *Commissioner*, 326 U. S. 521 (1946) that the Tax Court's decision in the instant case has no warrant in the record and no reasonable basis in law. In the *Kelley* case, all characteristics of the debentures which were material to the issue of the deductibility of interest on the debentures were substantially identical with those of the instant case, and in the *Kelley* case this Court affirmed the Tax Court's decision which held that such interest was deductible as interest on indebtedness.

This Court reviewed along with the *Kelley* case a companion case, *Talbot Mills* v. *Commissioner*, where the facts were substantially different from those of the *Kelley* case. In the *Kelley* case, the Circuit Court of Appeals for the Seventh Circuit reversed the Tax Court's holding that the interest was deductible. In the *Talbot Mills* case the Tax Court held that the interest was not deductible and the Circuit Court of Appeals for the First Circuit affirmed that

holding. This Court reversed the decision of the Seventh Circuit Court in the *Kelley* case and affirmed the decision of the First Circuit Court in the *Talbot Mills* case, thus upholding the Tax Court's decision in each case. After pointing out the differences in the facts of the two cases, this Court said:

> "From the foregoing statements of facts, it appears that the characteristics of all the obligations in question and the surrounding circumstances were of such a nature that it is reasonably possible for determiners to reach the conclusion that the secured annual payments were interest to creditors in one case and dividends to stockholders in the other case."

Comparison of the Kelley Debentures with the Petit Anse Debentures

A comparison of the instant case with the *Kelley* case shows that the characteristics of the two issues of debentures in so far as they bear upon the question whether the debentures constitute indebtedness or stock are in all material respects substantially identical.

(a) The Kelley debentures were named "The John Kelley Company Twenty Year Eight Percent Income Debentures." The Petit Anse debentures were named "Eight Percent Registered Non-Cumulative Fifty Year Income Gold Debentures";

(b) The Kelley debentures were issued pursuant to a recapitalization agreement in exchange for stock theretofore outstanding. The Petit Anse debentures were likewise issued pursuant to a reorganization agreement in exchange for stock theretofore outstanding.

(c) The Kelley debentures were income debenture bearer bonds issued under a trust indenture. The Petit Anse

debentures were registered bonds also secured by an indenture which provided the terms and conditions under which they were issued. They carried 8% interest, non-cumulative, dependent upon the earnings of the issuing company.

(d) The Kelley debentures matured in 20 years from date. The Petit Anse debentures matured 50 years from date.

(e) The Kelley debentures had priority of payment over stockholders but were subordinated to all other creditors. The Petit Anse debentures were given priority of payment over stockholders and had equal rights with all other creditors.

(f) The Kelley debentures had no right to participate in management. The same is true of the Petit Anse debentures.

(g) Each of said two issues of debentures contained promises to pay definite sums at a fixed maturity.

From the foregoing comparisons it will be seen that the characteristics of the debentures and the terms of their issuance in all material respects are substantially identical.

The Tax Court in its opinion states (R. 66) that after the reorganization pursuant to which the debentures were issued, petitioner paid all of its earnings, including depletion reserves, to its registered debenture-holders as it had done before to its stockholders prior to the reorganization, and argues from this that the practice of petitioner did not change by reason of the issuance of the debentures. This statement ignores the fact that the debenture-holders each year were informed at the time the payments were made to them of the amount of such payments that constituted interest, to-wit, the amount of the net earnings paid to them, and the amount of such payments that con-

stituted payments on account of principal. It further ignores the obvious fact that after the debentures were issued, the payments were to the holders of such debentures, whereas prior to the issuance of the debentures the payments were to the holders of the capital stock. The individuals who received new stock and debentures in connection with the reorganization were entirely free to dispose of either their stock or their debentures, except that in the case of the debentures, not stock, they were required to offer the same to the petitioner before selling to a third party.

Also the findings of fact made by the Tax Court state (R. 54) that there was no obligation to pay interest unless the board of directors declared such payment. This is a complete misinterpretation of the terms of the indenture and of the debentures. The petitioner covenanted unconditionally to pay interest in each year up to the amount of eight per cent on the debentures to the extent that the surplus net income for the year would suffice (Ind. Art. Third) and left to the directors only the determination of the amount of surplus net income for each year. The provision relates to the declaration by the directors and relates only to the case, which incidentally never occurred, in which there might be a failure to pay out the entire surplus net income in any given year. This provision authorized the directors to declare and pay in a later year any surplus net income that may not have been paid out concurrently, but otherwise did not relieve the petitioner of its primary obligation to pay interest equivalent to the surplus net income up to eight per cent on the amount of the debentures outstanding.

The Tax Court presented a very full memorandum of findings of fact (R. 47-61). There is no controversy between petitioner and respondent in regard to any of the findings of fact, except in so far as the Tax Court in its

findings of fact placed an incorrect interpretation on a written instrument.

We do not understand, as the Circuit Court of Appeals below apparently thought, that the decisions of this Court in the *Kelley* and *Dobson* cases require that in every instance where a question is presented such as that here in issue the Appellate Courts must affirm the decision of the Tax Court. This Court should issue a writ of certiorari to review the instant case so that it may decide the question of whether appellate courts are required to affirm decisions of the Tax Court reaching opposite conclusions on such issue on substantially identical facts.

II

The decision of the court below, if not reviewed by this Court, is likely to result in a great amount of litigation over the deductibility of interest paid on income debentures; and in order to forestall such litigation, this Court should review the decision and lay down specific rules for the guidance of lower courts in such cases. The court below, by its summary affirmance of the Tax Court's decision on the authority of the *Dobson* case, appeared to be of the opinion that in every instance the Tax Court's decision on such question must be deemed final and not subject to review, regardless of the facts and circumstances and regardless of whether such decision conflicts with a conclusion reached by the Tax Court in another case on substantially similar facts and also regardless of the provisions of Sec. 1141 (c) of the Internal Revenue Code.

It thus appears, according to the view which is implicit in the opinion of the court below, that the decision on the question must turn in each case on the individual views of the particular judge of the Tax Court who hears the case. If that should be considered the rule, the result would be chaotic indeed. Taxpayers and their legal ad-

visers would be compelled to sail in the dark on an uncharted sea, not knowing from day to day or year to year whether interest paid on their obligations is an allowable income tax deduction. This would mean that in every instance it would be necessary to litigate the question before the Tax Court or some other Federal court. If the question should be litigated before the Tax Court, the taxpayer would be denied review and must abide by the decision of the particular judge who hears the case, even though his decision is in conflict with a decision of another judge of the same court. On the other hand, if the question is litigated before some other Federal court, the taxpayer will have a right of review by an appellate court. Thus, under that rule, a decision of the Tax Court would merely decide the particular case and would not operate as a precedent in another case.

The *Dobson* and *Kelley* cases do not appear to stand for any such rule. It is clear from this Court's opinion in the *Dobson* case and in the *Kelley* case that appellate courts are required to determine whether a decision of the Tax Court is in accordance with law or not. This court in the *Kelley* case, after reviewing the facts, which were not in dispute, held that there was reasonable basis for the Tax Court's decision, thus holding in effect that there was no "clear-cut mistake of law." It would seem that when, as in the instant case, the Tax Court on similar facts reaches a conclusion contrary to its conclusion in the *Kelley* case, a clear-cut mistake of law is presented.

In setting forth its reasons for regarding a decision of the Tax Court as final where there is no clear-cut mistake of law, this Court said in the *Dobson* case (320 U. S., p. 499):

> "Consideration of uniform and expeditious tax administrations require that they be given all credit to which they are entitled under the law.

> The Tax Court decisions are characterized by substantial uniformity."

It appears to follow that in cases where none of the facts are in dispute, which present the same issue and where the material facts are substantially the same, but where two decisions of the Tax Court are conflicting, one or the other is obviously not in accordance with law, and it is within the province of appellate courts to review the Tax Court's decisions in order to determine which of them are in accordance with law and which are not. Determination of such question is plainly within the reviewing authority of Circuit Courts of Appeals under the provisions of Section 1141 (c) (1) of the Internal Revenue Code (see *Dobson* v. *Commissioner*, 320 U. S. p. 494).

In *Commissioner* vs. *Swent*, C. C. A. 4th, May 8, 1946, 155 F. (2d) 513, the question was whether the taxpayer was a *bona fide* non-resident of the United States for more than six months during the taxable year and therefore exempt from tax on certain income. The Tax Court granted the exemption and the Circuit Court of Appeals reversed, saying the answer to this question depended upon the interpretation of the words, a

> "bona fide non-resident of the United States for more than six months during the taxable year."

and also that this question is——

> "a question of law, so that we are not bound to follow the decision of the Tax Court under Dobson v. Commissioner, 320 U. S. 489."

As this Court recognized in the *Dobson* case, one of the chief purposes of Congress in creating the Board of Tax Appeals, was to establish uniformity of procedure and decisions in tax controversies. There are sixteen members of the Tax Court, and many of its decisions are rendered

by one judge only. Such decisions are sometimes in irreconcilable conflict with others, as is well illustrated by a comparison of the Tax Court's decision in the instant case with its decision in the *Kelley* case. The decisions of the Tax Court in the *Kelley, Talbot Mills* and the instant cases were each rendered by one judge and none was reviewed by the entire Tax Court. It would defeat the very purpose which Congress had in mind in creating the Board of Tax Appeals if such conflicting decisions must be deemed final and not subject to appellate review. This is particularly true where there is no factual issue and the only question is one of law.

It is submitted that the holding of the court below, that the Tax Court's decision is not reviewable, must necessarily result in confusion and uncertainty and that this Court should review that decision and clarify the rule on such question.

Conclusion

For the foregoing reasons, it is respectfully submitted that this petition for writ of certiorari should be granted.

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Dated: August 7, 1946.

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In the Supreme Court of the United States

October Term, 1946

No. 373

PETIT ANSE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 47–69) is not reported. The opinion of the Circuit Court of Appeals (R. 127–130) is reported in 155 F. 2d 797.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 9, 1946. (R. 131.) The petition for a writ of certiorari was filed on August 8, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Does the record contain substantial evidence supporting the determination by the Tax Court that the payments made during the taxable years by taxpayer to holders of its "debentures" were not "interest" on "indebtedness", within the meaning of the controlling statutes?

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title.
>
> * * * * *
>
> SEC. 115. DISTRIBUTIONS BY CORPORATIONS.
>
> (a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money

> or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.
>
> * * * * *

Sections 23 (b) and 115 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and of the Internal Revenue Code (26 U. S. C. 1940 ed., Secs. 23 and 115) are identical with the above.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 23 (b)–1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *
>
> * * * * *
>
> * * * So-called interest on preferred stock, which is in reality a dividend theron, cannot be deducted in computing net income. * * *

Article 23 (b)–1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, and Section 19.23 (b)–1 of Treasury Regulations 103, promulgated under the Internal Revenue Code, are identical with the above.

STATEMENT

This controversy involves deficiencies in income and excess profits taxes for the years 1937, 1938 and 1939. (R. 69–70, 131.) The Tax Court made findings of fact as follows:

Avery Island, Louisiana, contains rock salt deposits. Judge Daniel Dudley Avery was the owner of the island at the outbreak of the Civil War. At the approximate date of his death in 1876 the ownership of Avery Island passed to his children, in whose hands and in the hands of their families, ownership, either directly or indirectly, has remained at all times material. (R. 48.)

Desiring to separate the agricultural interests from the salt mining interests in Avery Island, the four children of Judge Avery, as its owners, in 1903 organized a Louisiana corporation, Avery Planting & Improvement Company (sometimes below referred to as "Planting Company"). (R. 49.) In 1910 another Louisiana corporation called Avery Company was formed, to which eventually all four children of Judge Avery transferred their interests in the salt mines. (R. 50.) The charter of Avery Company, as well as that of the Planting Company, contained a prohibition on the sale or transfer of stock to others than stockholders, unless first offered for sale to the stockholders. (R. 50.)

Taxpayer is a Delaware corporation (R. 47) formed in 1924 in a reorganization of Avery Com-

pany and in order to take over its interests in Avery Island (R. 51). Taxpayer's stock was issued to stockholders of Avery Company in exchange for their stock in that company. In 1930, taxpayer was the owner of the salt deposit on Avery Island and was engaged in no activity other than that of holding title to this property, then leased for a term ending in 1951. Its only income was the rental from the lease. In 1930 and for some years prior thereto, the Planting Company was engaged only in leasing its property for mineral and oil exploration and for trapping and grazing purposes. (R. 51–52.)

Consideration was given to the reorganization and combination of taxpayer and the Planting Company, and in January 1931 taxpayer's directors adopted a plan which provided generally as follows:

1. Taxpayer would issue $1,000,000 of eight percent income debenture bonds and would offer these bonds to its stockholders pro rata, upon surrender by them in exchange therefor of 9,000 shares of its stock, each stockholder to surrender nine-fifteenths of the stock held by him or her respectively. (R. 52.)

2. Taxpayer would offer pro rata to the stockholders of Planting Company, in exchange for 1,000 shares they held in that company, 4,000 shares of the 9,000 shares of taxpayer's stock which were to be surrendered. (R. 52.)

3. If the plan should be approved, the charter

of taxpayer would be amended to prohibit it from engaging in any active business involving liability and to restrict its corporate purpose to the holding, care, upkeep, and leasing of its properties. (R. 52–53.)

4. After execution of the plan, the "capitalization" of taxpayer would be eight percent income debenture bonds, $1,000,000; shares of stock (no par value), 10,000. (R. 53.)

The debentures issued pursuant to this plan were dated November 1, 1931, and were designated "Eight Per Cent. Registered Non-Cumulative Fifty Year Income Gold Debenture", with a stated due date of November 1, 1981. They recited that they were issued under and subject to an indenture of even date, entered into between taxpayer and Joseph S. Clark, Jr., and Frank McLoughlin, as trustees. The indenture provided that beginning on February 1, 1932, and out of taxpayer's surplus net income for the fourth quarter of the calendar year 1931, and thereafter quarterly on May 1, August 1, and November 1, out of taxpayer's surplus net income for corresponding quarters, taxpayer's directors might pay interest on the debentures to the extent such surplus net income should be sufficient for the purpose, and, if not sufficient, then pro rata. Although the interest periods were named and the particular surplus net income was described out of which the interest at such periods might be paid, the directors had the right to dis-

tribute at any time, on account of any quarterly installment of interest payable in any calendar year, any surplus net income of that quarter, or of any other quarter of such calendar year, available for the purpose; but the total amounts distributed as interest at or for the four quarterly interest periods in any calendar year were not to exceed eight percent. (R. 53–54.)

The term "surplus net income" was defined in the indenture as follows (R. 54, 137):

> * * * the surplus remaining after deducting from the gross earnings or income of the Company all of its operating expenses, including maintenance, repairs, renewals, replacements, insurance, losses, damage claims and proper charges in respect of depreciation and obsolescence and all sums paid or reserved for taxes, assessments or other governmental charges and such sums paid or reserved for alterations, additions and improvements as in the judgment of said Board may be deemed necessary or desirable. * * *

Interest upon the debentures was not to be cumulative. No interest was to be due and payable unless declared by the board of directors out of taxpayer's surplus net income, and their determination as to whether there was any "surplus net income" in any year and its amount was binding upon taxpayer and the debenture holders. (R. 54, 138.) When the surplus net income for a given year is sufficient to pay in full the interest

for that year and the full amount of eight percent for that year is not paid, the directors may at any time after such year use such surplus net income to pay in full the unpaid portion of the interest for such given year. (R. 54.)

By giving 60 days notice, taxpayer has the right to redeem any or all of the debentures on any interest date, prior to maturity; selection of the particular debentures to be redeemed is to be determined by taxpayer's board of directors, in its discretion. (R. 54–55.)

In the event of default by taxpayer in the payment of interest or of principal, or in the performance of any of the provisions of the indenture, and when the default has continued for a period of 60 days without being remedied, the trustees may, and upon request of 60 percent of the holders in amount of debentures outstanding shall, declare the principal of all the debentures due and payable. The holders of 60 percent have the right to waive any event of default and its consequences, and may rescind any action of the trustees in declaring the principal of the debentures due and payable. (R. 55.)

All rights of action in respect of the debentures are vested exclusively in the trustees, and no debenture holder has any right to bring any action, at law or in equity, upon any debenture or growing out of any of its provisions or of the indenture or for the enforcement of the indenture, unless the trustees have refused and neglected to

institute proper proceedings for a period of 60 days after having been requested to do so by the holders of 60 percent in amount of the debentures outstanding. (R. 55.)

The indenture was not to be recorded or registered in any public office, and further provided that the only parties interested in taxpayer, as debenture owners, were descendants of Judge Avery, and that it was their intention that no party should become the owner of any of the debentures except descendants of Judge Avery, and that each debenture holder agreed that, before selling his debentures to any one other than a debenture holder, he would first offer them to taxpayer, which would have a 30 day option to purchase them at the same price at which a bona fide offer had been received from outside sources. (R. 55–56, 139–141.)

Taxpayer and all of its property were to be liable for the payment of the debentures. Debenture holders, as such, were not given any right to participate in the management of the business. (R. 56.)

The trust indenture was executed and the debentures were issued as of November 1, 1931, to the fifteen descendants of Judge Avery, who had been stockholders of taxpayer and of the Planting Company at the time of the reorganization. (R. 57–58.) Nevertheless, taxpayer's balance sheets at December 31, 1931, and December 31, 1932, appearing as parts of its 1931 and 1932 income tax

returns, indicate that the issuance of the debentures under the plan was not reflected on taxpayer's books until sometime in 1932. Except for land valued at $62,500, buildings at $1,200, and $489.16 in cash received in July 1932, upon liquidation of the Planting Company, no new assets were received upon the issuance of the debentures, taxpayer's assets merely being written up as good will in the amount of $932,010.64. (R. 58.)

From the organization of taxpayer through 1927, the $20,000 fixed annual rental, payable monthly, under the salt mining lease and the quarterly rentals based on production were paid directly by the mining company to its stockholders, in proportion to their stockholdings. During 1928, and up to November 1, 1931, the effective date of the reorganization, these rentals were first paid to taxpayer and by it paid over to the stockholders in the same proportions. (R. 59.) The payments actually made by taxpayer's treasurer, whether from "receipts" or out of "surplus net income", after November 1, 1931, were to exactly the same individuals and in the same proportions as before November 1, 1931, except that for the months of January through October 1931, distributions allocable to E. A. McIlhenny, John A. McIlhenny, Paul A. McIlhenny, and Rufus A. McIlhenny, to the extent of $27.27 each, apparently had been paid to Sarah A. Mc-

Ilhenny. Subsequently and through the taxable years, except for some small changes resulting from shifts of debentures between various members of the Avery family, the distributions or payments to the debenture holders and/or stockholders of taxpayer continued to be made in the same proportions as before the reorganization. (R.60–62.)

The deductions of $34,577.11, $32,661.88 and $23,878.14 taken by taxpayer in its income tax returns for 1937, 1938 and 1939, respectively, as interest paid on its debentures in those years, were disallowed by the Commissioner in determining the deficiencies presently involved. (R. 64.) The Commissioner's determinations were sustained by the Tax Court (R. 64–69), and by the court below (R. 128).

ARGUMENT

The question whether payments upon hybrid corporate securities such as are here involved are to be treated as "interest" or as "dividends" was recently considered by this Court in two cases, *John Kelley Co.* v. *Commissioner* and *Talbot Mills* v. *Commissioner,* reported together at 326 U. S. 521. The opinion in those cases also sets forth the narrow scope of review with respect to such questions in cases coming from the Tax Court. The decision of the court below in the instant case is in accord therewith, and it would seem that no

useful purpose would be served by further review herein. The petition should be denied.

Respectfully submitted.

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